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UNCLAS SECTION 01 OF 02 TEL AVIV 005892

SIPDIS

SENSITIVE

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TAGS: ECON EFIN IS ECONOMY AND FINANCE
SUBJECT: BOI FOLLOWS FED AND RAISES INTEREST RATE TO 3.75 PERCENT

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Summary

¶1. (U) On September 25, the Bank of Israel (BOI) announced a .25 percent increase in interest rates, bringing the short-term rate to 3.75 percent. This was the first change since the Central Bank lowered rates by 0.2 percent to 3.5 percent at the end of January, 2005. In its September 25 press release, the Bank noted that the decision to raise rates was made in order to maintain price stability, which it defined as an inflation rate of between one and three percent. Stanley Fischer, the Central Bank Governor, is known to prefer an inflation rate of about 2 percent, the midpoint of the target. In addition to watching inflation, the Bank of Israel will continue to take the interest rate decisions of the FED into account in determining its monetary policy. End Summary.

Fischer's First Rate Change

¶2. (U) The increase was the first action on interest rates by Fischer since he joined the BOI in May, 2005. Following the FED's decision on September 20 to raise rates, there had been speculation as to whether the BOI would follow suit. The Governor said in an interview in the September 23 Yediot Aharonot that, "there is no doubt that an increase in rates in the U.S. would influence Israel and that the Central Bank would have to raise rates." He added that the factors which contribute to inflation would also lead to an increase in rates.

Increase Foreshadowed at the End Of August

¶3. (U) In its August 29 statement announcing that interest rates would remain unchanged at 3.5 percent, the BOI noted increased inflationary pressures evidenced by the higher than expected 1.1 percent rise in the July CPI. The statement said that the Bank would not hesitate to raise rates if warranted by increased inflation. Although the CPI in August was only 0.2 percent, inflation forecasts for the next year have risen as high as 2.4 percent, higher than the 2 percent BOI goal.

Factors Behind the Hike

¶4. (U) The BOI cited the following reasons for raising the interest rate:

- Devaluation of the shekel against the dollar; the shekel declined by 1.2 percent in the last month.

- Recent increases in global oil prices; this was cited as contributing to pricing pressures in Israel. Fischer said in a September 23 Haaretz interview that increases in oil prices in the 1970s and 1980s had a one-time influence on prices, but the present situation is much more complex, resulting in a continuous process of increased oil and raw material prices.

- The "relatively low level of short-term real interest rates against the background of relatively rapid economic growth intrinsically exerts a certain pressure on prices." Over the last few years when inflation was very low, and fell below the 2percent target, some economists claimed that this was an indication of a low level of economic activity, and therefore nothing to celebrate. In the present era of accelerated growth, prices will likely rise.

- Persistent political and economic uncertainty; The interest rate announcement was made before knowing the outcome of the Likud Central Committee vote on moving the party primary forward. However, the unclear time frame for the planned national political elections in 2006, and the continuing problematic security situation have resulted in political uncertainty, which impacts on the financial markets and affects inflation. It also affects perceptions regarding economic stability, calling into question the government's ability to maintain its reform program and its policy of fiscal restraint, particularly as the Budget approval season approaches.

U.S.-Israel Interest Rate Differentials

¶5. (U) The Fed action on September 20 raising interest rates to 3.75 percent created an historical anomaly in which the short-term interest rate in Israel was lower than in the United States by .25 percent. However, Israel's long-term rates continue to be about 1.8 percent higher. As Fischer noted in a September 23 Haaretz interview, this interest rate differential encourages Israelis to invest in the shekel and keeps them from sending their money abroad. He added that conventional thinking used to require about a 2 percent differential between U.S. and Israeli long-term rates (Comment: to prevent capital flight out of Israel; end comment), but "we saw that when confidence in macroeconomic policies increases, it is possible to reduce the gap to zero."

Reactions Good, but Hope it's Not a Trend

¶6. (U) The reaction of Ohad Marani, Former DG of the Finance Ministry, and currently Chairman of the Economic Committee of the Manufacturers Association, typified the general praise within Israel's economic sector of the decision to modestly raise rates. He told Haaretz on September 27 that he hopes the decision does not presage further increases that could eventually curb growth and employment.

¶7. (U) Jonathan Katz, Chief Economist of Leader and Co., interviewed by The Marker on September 27, said on the other hand, that the rate increase was puzzling and the accompanying BOI statement worrisome. He noted that the BOI in the past had neither an interest rate differential target nor an exchange rate target. He said that the prevailing perception that the BOI was setting such targets should worry the Israeli capital markets. He explained that interest rate hikes in the U.S. to as much as 4.5 percent in 2006 could lead to a similar trend in Israel. Given continued high unemployment (9 percent) and the ongoing process of recovery, Katz does not want to see an acceleration in interest rate hikes.

Comment

¶8. (SBU) The rate hike was likely a preemptive strike against the inflationary pressures that are starting to build up in the Israeli economy, driven primarily by increased energy prices. This week, standard grade gasoline prices in Israel have reached the 6 shekel per liter level for the first time ever. In addition, the Central Bureau of Statistics just released its prediction that the economy's overall growth rate for 2005 will be 5.1 percent, which could further spark inflation fears in a country where the hyperinflation of the 1980s is still remembered by many.

¶9. (SBU) The degree to which the BOI is seen to be tying its monetary policy to that of the FED might raise a concern among many in the economic sector that further hikes in tandem with the FED could stifle Israel's recovery. However, the BOI had good reason now to raise rates modestly in order to head off inflation pressures, regardless of the FED's action. It will likely act independently in the future as well to stave off inflation while continuing to nurture economic growth.
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